THE HUGHES INVESTIGATION

I

Shortly after the panic of 1907 began, a rumor became current that "Wall Street" had designedly caused it in order to knock down the prices of stocks, frighten weak holders, and profit by the ruin of the community. This conception derived some plausibility from the fact that stocks had taken a sudden and violent downfall without any apparent reason, and that this fall continued increasingly from day to day. All eyes were fixed upon the declining quotations and all ears were filled with the clamor of "the street." The losers naturally looked for some other explanation of the *débâcle* than their own folly. Many onlookers mistook the effect for the cause. The immediate cause was a simultaneous rush to sell securities, by holders who perceived that there was trouble in the money-market, and who wanted cash to meet maturing obligations. These holders were not Wall Street men merely, but people in all parts of the country who had invested some part of their savings in stocks and bonds. The very *raison d'être* of the stock exchange is to supply a market where invested capital can be quickly turned into cash, and vice versa. The remoter cause of the panic was a long course of speculation in all kinds of property, real and personal, that had pervaded all parts of the country, and many parts of the old world, and had now reached its climax.[1]

The Samsons of Wall Street did not pull down the temple of finance on their own heads in order to slaughter a countless number of Philistines. They suffered mortal terror while the panic continued, and they did not escape wounds and bruises, which some of them are still carrying. Nevertheless, the rumor that they had brought on the panic by design and in selfish disregard

[1] In the *Yale Review* for May, 1909, Mr. Eugene Meyer, Jr., has shown conclusively that speculation on the stock exchange was not the chief contributor to the collapse of 1907, but that speculation on a much wider scale, through the length and breadth of the land, was the exciting cause.

of public interests, had a wide circulation, and was fraught with possibilities of mischief. The danger of ill-considered legislation, supported by ill-advised public opinion, doubtless moved Governor Hughes to appoint a committee of persons, equally removed from financial cliques and from partisan politics, to inquire "what changes if any are advisable in the laws of the state bearing upon speculation in securities and commodities, or relating to the protection of investors, or with regard to the instrumentalities and organizations used in dealings in securities and commodities, which are the subject of speculation."

The committee was in session about six months. Its expenses were paid by the members themselves, and since frugality was a necessity the services of the stenographer were dispensed with, the members taking only such notes of the testimony of witnesses as each one deemed important to the matter in hand. The officers of all the exchanges in New York City were invited to appear before the committee and answer questions both orally and in writing, and all of them responded promptly and courteously, as often as they were asked to do so. Many volunteer witnesses, citizens of the state, were heard. None such were refused a hearing. Citizens of other states were not called, or accepted, as witnesses unless they had given evidence, by published writings or otherwise, that they had something of value to contribute to the discussion.

Before considering in detail the conclusions reached by the committee, let us glance at the subject in its general aspects.

II

An exchange is a common meeting-place of buyers and sellers. Such meeting-places have existed from the earliest times. The Agora of ancient Greece was an open-air market before it acquired any political or judicial character. The time of "full market" became a colloquial division of the day corresponding to our "high noon," except that full market was about an hour before noon. The Forum of Rome was likewise an open-air market (*foris,* out of doors) before it became the place for holding the *comitia,* and listening to public speeches. Buying and

selling continued in the Forum until the crowds became too dense for the proper transaction of business. Then the traders gradually withdrew and established smaller fora in different quarters of the city, one for fish, another for grain, another for wood, etc.; but the moneylenders held their places on the outskirts of the great Forum till the latest period. If there had been any stock-market in the ancient world it would, doubtless, have been in close proximity to the money-market.

The primary function of an exchange is the buying and selling of the several kinds of property for which the particular trading-place exists. A secondary, but not less important, function is the ascertaining and publishing of prices, so that producers may know what they can obtain for their products, and purchasers what they must pay for them. Prices are made by the competition of buyers and sellers in open market under the spur of self-interest, and there is no other way in which they can be legitimately made. Wherever quotations are not based on open trading they are, at the best, the result of haphazard guesses, and, at the worst, positive fraud on producers or consumers. A still further service rendered by exchanges is the making of regulations governing the practices of different branches of trade.

Speculation is the act of taking advantage of fluctuations in the prices of property. Such fluctuations are occurring at all times, because we live in a world of change. They are due to a variety of causes both physical and psychological. Among the former may be mentioned wars and rumors of war, vicissitudes of the crops, storms, floods, drought, insect pests, earthquakes, commercial legislation, decisions of the courts, labor troubles, etc. Among the latter the temper of the business community, of which the banking community is a part, is the most potent. This is seldom in a state of quiescence, but ranges between hopefulness and depression, from blind confidence to blind panic. The physical, or external, causes are the controlling ones in the long run, but the governing force at any particular time is the state of opinion prevailing on the exchange. This may be in part artificial or "manipulated," but it represents the law of supply and demand at the moment. Thus the price of wheat may at any time

be higher or lower than the facts of world-supply and world-demand warrant, because the statistics are defective or disputed. Contradictory opinions as to the real facts meet on the exchange. Bulls and bears struggle with each other and the trades which they actually make show the prices at which anybody can immediately sell his holdings or supply his wants. This is true of all the exchanges, although the stock exchange deals in invested capital instead of consumable commodities.

When we consider the vastness of the business transactions and the incessant fluctuations in price, we cannot be surprised that certain persons seek to take advantage of them—that is, to speculate; nor that some of the speculators seek to cause fluctuations in order that they may profit by them. Probably there is never a time when somebody is not seeking to raise or depress prices artificially.

Although the number of persons admitted to the floor of an exchange is limited, the number of traders is unlimited, since anybody in the world, who has capital or credit, can participate, by simply filing an order in the nearest telegraph office. The art of telegraphing has reached such perfection that a question and an answer to it can be exchanged between the London and New York stock exchanges in three minutes. In some periods of active trading three thousand cablegrams are received at the New York Stock Exchange from Europe in a single day, while telegrams from our own country are innumerable.

Each fall in prices brings in buyers whose purchases minimize the decline and each rise opens the door for sellers whose sales minimize the advance. In both cases short sellers play a useful part, helping to lessen the advance in the latter case and (by covering) to lessen the decline in the former.

The selling of property for future delivery, by persons who do not immediately possess it, is believed by many to depress prices artificially, to the disadvantage of the producer. This is a fallacy, since every sale requires a purchase of equal magnitude. Nevertheless, it is a constantly recurring fallacy, and it is proper to notice it here.

A manufacturer of cotton goods, for example, in order to

keep his mill running all the year round, must make contracts ahead for his material, before the crop of any particular year is picked. The cotton must be of a particular grade. He wishes to be insured against fluctuations in both price and quality; for such insurance he can afford to pay. In fact, he cannot afford to be without it. There are also men in the cotton trade, of large capital and experience, who keep themselves informed of all the facts touching the crops and the demand and supply of cotton in the world and who find their profit in making contracts for its future delivery. They do not possess the article when they sell it. To them the contract is a matter of speculation and short selling, but it is a perfectly legitimate transaction. To the manufacturer it is virtually a policy of insurance. It enables him to keep his mill running and his hands employed, regardless of bad weather or insect pests or other uncertainties. The same principles apply to the miller who wants wheat, to the distiller, the cattle-feeder, and the starch-maker who want corn, to the brewer who wants hops and barley, to the brassfounder who wants copper, and so on indefinitely.

Insurance is one of two redeeming features of such speculation; and the other, which is even more important, is the steadying effect which it has on market prices. If no speculative buying of produce ever took place, it would be impossible for a grower of wheat or cotton to realize a fair price at once on his entire crop. He would have to deal it out little by little to merchants who, in turn, would pass it on, in the same piecemeal way, to consumers. It is speculative buying which not only enables farmers to realize on their entire crops as soon as they are harvested, but enables them to do so with no disastrous sacrifice of price. When buyers who have future sales in view compete actively with each other, farmers get fair prices for their produce.

There is a widespread belief that Wall Street and the stock exchange are one and the same thing, and that all the fluctuations on the exchange are caused by Wall Street. This is an error as glaring as it would be to suppose that all the water in the Mississippi River comes from the adjacent banks, ignoring the innumerable streams and rills that contribute their quota from

countless unseen sources. Wall Street and the stock exchange are two different things. The men on the floor of the exchange are the agents of others, executing the orders which they receive both from Wall Street and from other parts of the habitable globe. Some of them speculate on their own account, but the speculating members of the exchange are divided into bulls and bears. They do not all push in the same direction at any one time. They simply aim to anticipate, each for himself, the drift of financial public opinion in order to take advantage of it.

This is what Wall Street outside of the exchange does; and the only advantage which speculators in Wall Street have over those in other parts of the country is derived from larger capital, more direct and ample sources of information, and greater skill and promptness in the use of it. Wall Street speculators are likewise divided into bulls and bears pushing against each other; and all their advantages do not save them from making mistakes, which often result in losses proportioned to the magnitude of their operations. The "rich men's panic" of 1903 was such an instance. The panic of 1907 was another. It is sometimes said that Wall Street can put prices on the stock exchange up or down at its own pleasure. This is a delusion. Anybody who can guess right six times out of ten can carry off all the stakes in any gambling game that is long continued. If Wall Street could do this, Wall Street would long ago have absorbed all the floating capital in the country and have retired from business for want of more pabulum.

The evils of speculation are moral, private, and personal. They are properly defined as those of the gambling spirit. The desire to get rich without labor has prevailed among men at all ages, and will doubtless continue as long as human nature remains unchanged. If speculation is more rampant today than at any former period of the world's history, it is merely because there are more people to speculate, and more facilities for speculation. The growth of capital is itself an incitement to speculation, since it supplies the things to speculate with. The exchange, the telegraph, the telephone, the press, the banks, and the ticker are instrumentalities which lend themselves to the promotion of the

gambling spirit, yet it would be unwise to suppress them on that account.

Speculation is of different kinds and degrees. The man who buys for investment today, may sell tomorrow if the thing has advanced in price. He may or may not have had that intention when he bought. In either case it is speculation, since the selling insures him against subsequent decline and enables him to pocket the difference. From this example to that of the man who habitually "takes a flyer" on the exchange, and who, if anybody, may be called a stock-gambler, there are many gradations. The difference between speculation and overspeculation is hard to determine. It is necessary, however, to draw the line somewhere between trading and gambling, and the courts have ruled that a contract which is enforceable at law, i. e., when the buyer can compel the seller to deliver the property, and the seller can compel the buyer to pay for it, is legitimate, and that mere betting on the rise or fall of quotations, such as takes place in bucket-shops, is gambling. Although the greater part of the trading that takes place in the stock, produce, and cotton exchanges is of the speculative kind, and hence has a gambling taint, it is difficult to see how the line of demarkation could be drawn differently, in the administration of justice.

III

Governor Hughes's letter of appointment looked toward the evils of speculation as the main subject of inquiry. To analyze speculation, and to separate the bad features from the good (if any), was the first step to be taken.

Fluctuations in prices may be foreseen, or may be wholly the result of chance. They may be designed by the speculator beforehand and when they are successful they may or may not entail losses upon others. When losses are incurred they may fall upon persons who are able to bear them, or they may bring ruin and misery upon the speculators. Inasmuch as fluctuations will occur whether persons seek to take advantage of them or not, it follows that those whose business requires forecast, as nearly all business does, must speculate to some extent, although they

may not consciously use that term in making their bargains. Persons who look to the stock-market for investment purposes only, will naturally choose those securities which seem likely to advance in value. This, too, is speculation. From this colorless type to that of bucket-shop gambling there are many gradations.

The first question that confronted the committee was whether there was any practical way to discriminate between different kinds of gamblers. The law prohibits roulette, faro, policy shops, pool-rooms, race-track betting, and bucket-shops, all of which are gambling games on a comparatively small scale; why does it tolerate gambling on a large scale on the stock exchange? To answer this question by saying that the law makes betting illegal and contracts for the sale and delivery of property legal, merely leads to another: Why should not the law be changed so as to treat all gambling games alike? It is known that 75 per cent. of the trades on the stock exchange (some say 90 per cent.) are of the gambling type. Although the stocks bought and sold today must be delivered and paid for tomorrow, the intent of the buyer is to sell them as soon as he can get a satisfactory profit. Why make fish of one and flesh of another?

As there is no way to discriminate between individuals who give orders to brokers, or between the different brokers who execute them, this is really a question whether the stock exchange ought to be abolished. Indeed it goes much farther. It is a question whether all exchanges ought to be abolished and even whether all trading to supply one's future wants ought to be prohibited. Ought prudence, thrift, and foresight to be eliminated from the business world in order to prevent some persons from falling victims to their own folly?

Many days were spent in thrashing out this question, for it was deemed needful to give both sides a full hearing. In the examination of witnesses numerous lights were thrown upon the subject in hand. All the pros and cons of margin trading and short selling were discussed. The experience of England and Germany in dealing with speculation was sifted. The legislation of American states was overhauled. The debates in Congress on the Hatch Anti-Option Bill, extending over three years, were

examined. The work of the Industrial Commission was read. No available sources of information were neglected.

The conclusions announced by the committee were not hastily reached. It is safe to say that a majority of the members were and are averse to speculation in either securities or commodities, but that they were not able to devise any means of putting an end to it that would not do vastly more harm than good. One witness of high rank as an economist, Professor Emery, of Yale University, held that speculation in securities and commodities is a good thing for the world and that there can be no free and fair market without it. He instanced the futile efforts of Germany to get rid of speculation in business, which resulted in getting rid of the business but not of the speculation.

It does not follow that there is no possible mitigation of the evils of speculation. Those evils consist in the losses of persons not qualified to speculate—the moths who are attracted by the light of the exchanges and who flutter around the flame till their wings are burned off. These persons are always on the bull side of the market. They buy on margins, and the smaller the margin the larger is the number of victims and the greater is the business of the stockbrokers.

The customary margin is at least 10 per cent., paid to the broker, who furnishes 10 per cent. additional and borrows 80 per cent. from a bank. But there are certain inactive stocks whose quotations may vary more than 10 per cent. in a single day, simply because there is no buyer present when some holder is forced to sell. In such cases the required margin may be as high as 50 per cent. On the other hand the fluctuations in government, or state, or city bonds are so slight that a margin of 5 per cent. would be ample. Manifestly there can be no hard-and-fast rule applicable to all securities, but it may be safely surmised that if the initial margin were not less than 20 per cent. the number of fluttering moths would be lessened by one-half, if not more, and that the risks of the remainder would be reduced in a still greater ratio.

Can such a reform be accomplished? It is certainly worth striving for, but if possible at all it must be sought through moral

suasion. The right of one private person to extend credit to another is simply the right to make a contract, which, under the Federal Constitution cannot be impaired by any state legislature. It might, however, be curtailed by a rule of the stock exchange as to transactions taking place on its floor, if such a rule were enforceable, and if the benefits were likely to be greater than the injuries resulting therefrom. The committee, after devoting much time and labor to this question, put its conclusions in these words:

> In preference, therefore, to recommending legislation we urge upon all brokers to discourage speculation upon small margins, and upon the exchange to use its influence, and if necessary its power, to prevent members from soliciting and generally accepting business on a less margin than 20 per cent.

No member of the committee advised legislation on this subject. Some favored an inflexible rule of the exchange forbidding the acceptance of orders on a smaller margin than 20 per cent. The majority, however, looking at the loss of really sound business likely to be caused by such a rule, in respect of telegraphic orders, received from customers of known responsibility, both here and abroad, and mostly executed without waiting for margin, and looking also at the difficulty of enforcing any hard-and-fast rules, decided to stop short of prohibition, and merely point out the reform to be striven for by the influential authorities of the stock exchange. Anything more than this would have been futile, anything less would have failed to satisfy the public opinion which led to the appointment of the committee.

IV

Next to the losses arising from insufficient margins are those incurred through swindling advertisements and circulars. These are generally connected with quotations made by "wash sales" on some exchange, which indicate falsely that there is active trading in the securities advertised. Mines of gold, silver, and copper are the most frequent and fallacious baits held out to excite the cupidity of speculators. The mines are situated in distant places, as Nevada, Alaska, Canada, Mexico, and even

South America. In proportion as they are remote, inaccessible, and subterranean they are attractive to the class whom Tacitus had in mind when he said: *Omne ignotum pro magnifico.*

The New York Stock Exchange does not admit shady enterprises to its list and it forbids advertisements by its members of "other than a strictly legitimate business character"—the governors being the judges of what is legitimate. The curb market is under no such limitations. This is an open-air market without organization or written rules, where anybody can trade in anything, but no quotations made on the curb can be published without the consent of one individual, who exercises authority among his fellow-traders by common consent. Without imputing any bad designs to this individual it is easy to see that he is not likely to know much about the internal affairs of Rawhide Coalition, or Guanajuato, and that the mere fact of the admission of those and similar devices of the engraver's art to the trading list of the curb ought not to create any presumptions in their favor.

The committee found that the great bulk of the orders executed on the curb came through members of the stock exchange. If the members of the great exchange are allowed to trade in the small one directly or indirectly, then persons desiring to speculate on the latter will naturally prefer to deal with a well-known, responsible house rather than with a stranger, whose only roof during business hours is a cotton umbrella. So it has come to pass that 85 per cent. of the business done on the curb comes through members of the stock exchange. Obviously the stock exchange holds a club by which the curb can be reduced to order since, by merely passing a resolution, it can cut off the bulk of its business. An initial step looking to its reformation has already been taken.

The curb was not the only offender in this matter of advertising. In 1907 the produce exchange obtained from the legislature an amendment to its charter permitting it to deal in securities as well as in commodities. It then offered to the public some very questionable mining shares in the cobalt district of Canada, which were advertised extensively in the class of newspapers which are not very scrupulous as to the sources of their

income. This movement on the part of an old and respectable commercial body called for criticism on the part of the committee, and put the advertising evil in a still more glaring light, showing that even if the curb were reformed out of existence that kind of swindling might still continue.

The British "Companies Act" forbids the public advertisement or sale of any securities unless the issuing company has been registered in a bureau of the government with information regarding the business to be transacted, the names of the officers and other persons responsible for the statements of fact, etc. Much time was spent by the committee in discussing the advisability of adopting the English system, regardless of the fact that it would be operative in only one state of the union, and that it would serve as an obstacle to all securities, sound and unsound alike. Thus, if the Pennsylvania Railroad Company desired to issue a new lot of bonds it could advertise and sell them everywhere except in New York, without the trouble and expense of registration. Would it be worth while to give to other markets such an advantage over that of New York? The opinion of the governors of the stock exchange was sought and was given orally, to the effect that it would be unwise to take that risk unless the benefits to be derived from registration were preponderating and reasonably certain. It was their belief, however, that a certificate from state officials that a company was registered at Albany would be interpreted by the class of investors who are most liable to deception, as a certificate of the soundness of the securities, in which case the act of registration would do more harm than good. The latter consideration prevailed in the committee, but recommendations as to advertising were made, which, if adopted by the legislature, will add something to the responsibilities of greedy and unscrupulous newspapers, while not going upon the doubtful ground of a censorship of the press.

The committee suggested that the stock exchange should adopt a rule providing that the governors shall have power to decide when a corner exists and to fix a settlement price, so as to relieve innocent persons from the injury or ruin which may result therefrom. The governors of the exchange, when interrogated, did

not concur in this suggestion, since it would put a limit on the liabilities incurred in short selling, which they were not prepared to sanction.

There is force in this objection, but the probability is that if such a rule existed there would never be another corner, since the motive for producing it would no longer exist. A corner, in its dictionary meaning, is an artificial contrivance designed to produce a scarcity. It does not include cases of real scarcity where, for example, opposing parties, aiming at control, not scarcity, bid up the price of a stock to inordinate figures, as in the Northern Pacific case of 1901. Under the proposal of the committee the governors of the stock exchange would decide in every such case whether the scarcity was artificial or real, and if artificial would fix a settling price. Corners in the stock-market are of very rare occurrence. If the proposed rule were adopted, probably the governors would never have occasion to take action under it. The recommendation of the committee has received the approval of so good an authority as the *Financial Chronicle*.

Differences of opinion arose in the committee as to the advisability of requiring periodical examinations of the books of brokers, corresponding to the examinations of national banks, with the view of preventing or minimizing failures; also as to the rehypothecating of securities of customers bought on margin; also as to the incorporation of the stock exchange in order to subject it more immediately to state control, etc. In the settlement of debatable points the opinion prevailed that methods of doing business which had been approved by long experience should not be changed arbitrarily or without very good reasons, and that in cases where reforms were imperative (as in the reformation of the curb market) they should be initiated and carried through by the exchanges themselves, or at all events that the opportunity to effect such reforms should be given to those agencies before other powers were invoked.

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